

A Brief on the Report of the Committee on Taxation of E-Commerce

- CA Sachin Kumar B.P and CA Omar Abdullah S.M

Part – A

Introduction

The digital wave of doing business has usurped traditional industries and is continuously causing disruption across industries. The international tax administration authorities have been grappling with innovative digital business models such as multi-sided markets with archaic taxation laws which date back to the post World War – II era of league of nations. The overhauling of the international tax laws in view of the rapid changes caused by digital disruption has long been due. The Organization for Economic Corporation and Development (OECD) along with the G-20 Nations has undertaken the Base Erosion and Profit Shifting Project (BEPS Project) to adapt international tax laws to current business models and digital business has been a major focus area of the BEPS Project.

India has been an active contributor to the BEPS Project at the same time in February 2016, the Report of the Committee on Taxation of E-Commerce (the Report) has been published. The committee had been appointed by the Central Board of Direct Taxes (CBDT) whose term of reference included detailing the business models for e-commerce, the direct tax issues in regard to e-commerce transactions and suggested approach to deal with these issues under different business models. The committee in its report has heavily relied upon the BEPS Project Report on Action – 1, wherein the new business models of digital economy as well as the tax challenges arising from it in respect of nexus, characterization, valuation of data and user contribution have been examined in detail.

Part – B

Gist of the Report of the Committee on Taxation of E-Commerce

The Report is the first detailed analysis of the challenges faced by the Indian tax authorities due to the emergence of e-commerce. It is significant as it gives us professionals an insight into the course ahead by the Indian revenue authorities for dealing with international taxation of e-commerce. The Report is mainly divided into the following structure:

- Current Status of the Digital Economy and Future Growth
- Tax Challenges from Digital Economy
- Issues related to Value of Data & User Activity in Multidimensional Business Models
- Options to address broader tax challenges of Digital Economy in the Indian Context
- Recommendations

Current Status of the Digital Economy and Future Growth

As we are all aware that in the recent past the digital economy has been the greatest wealth creator with many start-ups gaining the coveted status of a tech unicorn, the Report takes this stellar growth story on record by recognizing this fact. The Report further discusses the future growth prospects of the digital economy in India by highlighting that India will have 500 Million Internet users by the end of 2016 and how the advent of Internet of Things (IoT) technology will be the driver of the next growth phase in the digital arena.

Tax Challenges from the Digital Economy

The Report focuses on the International Tax issues, which arise from the e-commerce business models. It recognizes that most of the international tax laws are based on the physical way of doing business. The Permanent Establishment (PE) concept which acts as a threshold for allocating taxing rights to a nation is no longer relevant in case of digital business, as digital businesses can be geographically separate and yet have a significant participation in the economy of a country unlike traditional business which will have to be physically present in a country to participate significantly in the economy of that country.

The Report discusses the Permanent Establishment concept from an historical perspective where the conceptualization of the Permanent Establishment is based on physical presence keeping in view certain industries of that time and the business models employed then and goes on to discuss the evolution of the Permanent Establishment with introduction of Agency PE and Service PE.

The Report recognizes that the physical presence based threshold, raises broader tax policy challenges for policy makers in the case of digital economy relating in particular to nexus, data and characterization for direct tax purposes. The report further discusses how these challenges trigger more systemic questions about the ability of the current international tax framework to deal with the changes brought about by the digital economy and the business models that it makes possible and hence to ensure that profits are taxed in the jurisdiction where economic activities occur and where value is generated. These challenges also raise questions regarding the paradigm used to determine where economic activities are carried out and value is generated for tax purposes, which is based on an analysis of the functions, assets and risks of the enterprise involved. At the same time, these challenges create opportunities for achieving double non-taxation, for example due to lack of nexus in the market country under current physical presence rules, coupled with lack of taxation in the jurisdiction of the income recipient leading to BEPS.

Issues related to Value of data & User Activity in Multidimensional Business Models

The Report recognizes that reliance on data, including in particular the use of big data is one of the significant characteristics of the digital economy. The distinguishing factor of the digital economy from the traditional forms of businesses being its ability to gather large amounts of data and to process and exploit this data

for furthering the ends of business and generating more value, particularly by tailoring product offerings based on this data. There are various methods employed by digital platforms for collection of remote data, ranging from direct online surveys seeking specific responses from users to indirect methods like analysis of user locations (Google Maps – Traffic Pattern) and online behavior. Increasingly, most of this data is **generated by the users themselves** (YouTube), and used by enterprises in a manner that significantly contributes to the profits arising in their business models.

The committee in its Report after analyzing the role and contribution made by the users by way of data, content creation and the networking benefits, has considered that users are a significant indicator of both nexus and creation of value in the jurisdiction of source. In the view of the committee as per the Report, the presence of users of a digital or telecommunication network in a multi-dimensional business model signifies value creation and economic participation in that tax jurisdiction, and should give rise to the threshold nexus for taxing that enterprise in that jurisdiction, particularly, when such user contribution is relied upon for earning income from that jurisdiction.

Options to address broader tax challenges of Digital Economy in the Indian Context

The committee in its Report in consonance with BEPS Project Report Action – 1 has considered the following three options to address broader tax challenges of Digital Economy:

1. New Nexus based on Significant Economic Presence
2. Withholding tax on digital transactions
3. Equalization Levy

Option – 1: New Nexus based on Significant Economic Presence

As the broader tax challenges in digital economy arise primarily from the difficulties in application of existing physical presence based nexus threshold that constitutes the definition of permanent establishment, the first option to address the tax challenges in digital economy proposes that “*significant economic presence*” should be considered adequate fulfillment of nexus between the taxable enterprise and the taxing jurisdiction. The option would require appropriate modifications of nexus rules in the tax treaties (‘permanent establishment’) as well as domestic laws (‘business connection’).

In Section – 8 of the Report, the work of reputed authors Peter Hongler and Pasquale Pistone (*Blueprints for a New PE Nexus to Tax Business Income in the Era of the Digital Economy – Peter Hongler & Pasquale Pistone*) has been discussed. The authors have proposed the following amendment to the definition of the PE to base it on Significant Economic Presence:

If an enterprise in one Contracting State provides access to (or offers) an electronic, database, online market place or storage room or offers advertising services on a website or in an electronic application used by more than 1000 individual users per month domiciled in the other Contracting State, such enterprise shall be deemed to have a permanent establishment in the other Contracting State if the total amount

of revenue of the enterprise due to the aforementioned services in the other Contracting State exceeds XXX per annum.

Option – 2: Withholding tax on Digital transactions

The second option considered in the report is application of a withholding tax on payments arising from within a tax jurisdiction, on digital transactions. In essence, this option is substantially similar to the withholding tax that already exists in respect of payments made as interest, dividend, royalty and fee for technical services in tax treaties. Such tax can be levied at a concessional rate, on the gross amount of the payment, and offers a relatively easier solution of addressing the tax challenges of digital economy, when applied as a standalone final tax. Alternatively, it can also be combined with the new nexus based on significant economic presence, as an effective means for collecting tax, particularly in the context of B2B transactions.

Option – 3: Equalization Levy

The third option considered in the report is the ‘Equalization Levy’. The word ‘Equalization’ represents the objective of ensuring tax neutrality between different businesses conducted through differing business models or residing within or outside the taxing jurisdiction.

The approach of equalization levy has already been used by some countries in order to ensure equal treatment of foreign and domestic suppliers. For example, in the area of insurance, some countries have adopted equalization levies in the form of excise taxes based on the amount of gross premiums paid to offshore suppliers. Such taxes are intended to address a disparity in tax treatment between domestic corporations engaged in insurance activities and wholly taxable on the related profits, and foreign corporations that are able to sell insurance without being subject to income tax on those profits, neither in the State from where the premiums are collected nor in the State of Residence.

Recommendations

As per the Report among the three options considered and which can be implemented by various countries under their domestic laws, the only option that appears to be feasible and can be resorted to, without violating the obligations under a Double Taxation Avoidance Agreement, is ‘*Equalization Levy*’.

The objective of Equalization Levy is intended to be a tax imposed in accordance with the conclusions of the BEPS Report on Action 1 that has been endorsed by G-20 and the OECD, on payments made for digital services to foreign beneficial owner, who enjoy an unfair advantage over their Indian competitors providing similar services by digital or more traditional means, with the objective for equalizing their tax burden with other businesses that are subjected to income-tax in India, without disturbing the existing tax treaties. Another objective of Equalization Levy is to provide greater clarity, certainty and predictability in respect of characterization of

payments for digital services and consequent tax liabilities, to all stakeholders, so as to minimize costs of compliance and administration and minimize tax disputes in these matters. The target transactions would be those conducted primarily through digital or telecommunication networks, heavily relying upon latest telecommunication technology, and thereby avoiding the need of a physical presence in India, i.e. transactions which lead to profits that are not appropriately taxed in India because of the limitations of the existing international taxation rules.

As per the Report if the Equalization Levy is to be imposed under the domestic laws of India, if it is not to be imposed on income, and if it is not to be covered by treaty obligations imposed by the tax treaties, then it will need to be separated from the laws determining the tax imposed on income in India. As the Equalization Levy on a transaction is, in any case, inherently different from a tax on income, it need not be included within the laws governing tax on income. Accordingly, the Report recommends to imposing the Equalization Levy through statutory provisions outside the Income-tax Act, 1961. Instead, the provisions for Equalization Levy can be included in the Finance Act. Past precedents exist for imposition of similar taxes on transactions, like the Security Transaction Tax (STT) and the Service Tax.

Part – C **Conclusion**

The international taxation landscape has been rapidly changing with the phased implementation by States, of the recommendations of the Action Plans contained in the BEPS Project Report. The Report of the Committee on Taxation of E-Commerce (the Report) has heavily relied on the BEPS Action Plan – 1 and provides a viewpoint from the perspective of the Indian tax authorities as to the course for dealing with the vexed issue of international taxation of e-commerce. The Report while recommending Option – 3 (Equalization Levy) out of the options considered makes a mention of the superiority of Option – 1 (New Nexus based on Significant Economic Presence) over Option – 3, but however proceeds with Option – 3, owing to the feasibility of Option – 1 arising out of treaty obligations. The Report has currently recommended 13 transactions as leviable to Equalization Levy in Section – 10 of the Report.

If the BEPS Action Plan – 15 (Developing a Multi-Lateral Instrument to Modify Bi-Lateral Tax Treaties), is speedily implemented, & the Permanent Establishment definition is modified to include 'Significant Economic Presence' criteria. Then, the Equalization Levy will have to be scrapped as the Report recommends it only as a stop-gap arrangement owing to the current lacunae in the international tax laws which is being exploited by Multi-National Enterprises to achieve Base Erosion and Profit Shifting in case of digital business models. Through this Article the author has made a humble attempt to bring to fore the highlights of the Report of the Committee on Taxation of E-Commerce and would recommend it as essential reading to gain detailed perspective on the course ahead for international taxation of e-commerce from the Indian perspective and to gain an in-depth understanding of Equalization Levy in itself.
